Assurance and Advisory Business Services

United States Postal Service

Financial Statements

Years ended September 30, 2003 and 2002 with Report of Independent Auditors

Ernst & Young

Ernst & Young LLP

United States Postal Service

Financial Statements

Years ended September 30, 2003 and 2002

## Contents

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# Report of Independent Auditors

Board of Governors
United States Postal Service

We have audited the accompanying balance sheets of the United States Postal Service as of September 30, 2003 and 2002, and the related statements of operations, changes in net capital (deficiency) and cash flows for each of the three years in the period ended September 30, 2003. These financial statements are the responsibility of the United States Postal Service's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the United States Postal Service at September 30, 2003 and 2002 and the results of its operations and its cash flows for each of the three years in the period ended September 30, 2003, in conformity with accounting principles generally accepted in the United States.

In accordance with *Government Auditing Standards*, we have issued our report dated November 14, 2003, on our consideration of the United States Postal Service's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, and contracts. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Ernst + Young LLP

November 14, 2003

## United States Postal Service

## Balance Sheets

| | September 30 2003 | September 30 2002 |
|---|---|---|
| | *(In Millions)* | |
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents *(Note 2)* | **$ 2,266** | $ 1,156 |
| Receivables: | | |
| Foreign countries | **744** | 592 |
| U.S. government | **359** | 125 |
| Consignment | **50** | 55 |
| Other | **144** | 137 |
| Receivables before allowances | **1,297** | 909 |
| Less allowances | **(106)** | (112) |
| Total receivables, net | **1,191** | 797 |
| Supplies, advances and prepayments | **366** | 327 |
| Total current assets | **3,823** | 2,280 |
| Other assets, principally revenue forgone appropriations receivable *(Note 8)* | **365** | 368 |
| Property and equipment, at cost: | | |
| Buildings | **19,759** | 19,513 |
| Equipment | **17,166** | 16,421 |
| Land | **2,809** | 2,776 |
| Leasehold improvements | **1,060** | 1,098 |
| | **40,794** | 39,808 |
| Less allowances for depreciation and amortization | **(18,717)** | (16,895) |
| | **22,077** | 22,913 |
| Construction in progress | **977** | 1,223 |
| Total property and equipment, net | **23,054** | 24,136 |
| Deferred retirement costs *(Notes 2, 6 and 7)* | **–** | 32,231 |
| Total assets | **$ 27,242** | $ 59,015 |



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| | September 30 | |
|---|---|---|
| | **2003** | **2002** |
| | *(In Millions)* | |
| **Liabilities and net capital (deficiency)** | | |
| Current liabilities: | | |
| Compensation and benefits | **$ 2,518** | $ 5,113 |
| Estimated prepaid postage | **1,349** | 1,500 |
| Payables and accrued expenses: | | |
| Foreign countries | **879** | 748 |
| U.S. government | **112** | 246 |
| Unexpended appropriations *(Note 11)* | **406** | 583 |
| Other | **1,863** | 584 |
| Total payables and accrued expenses | **3,260** | 2,161 |
| Prepaid box rentals, permit and metered mail | **1,925** | 2,011 |
| Outstanding postal money orders | **768** | 986 |
| Current portion of debt | **7,273** | 3,815 |
| Total current liabilities | **17,093** | 15,586 |
| Long-term debt, less current portion *(Note 5)* | **1** | 7,300 |
| Other liabilities: | | |
| Deferred retirement costs *(Notes 2, 6 and 7)* | – | 32,231 |
| Less current portion reported in compensation and benefits | – | (2,185) |
| | – | 30,046 |
| Workers' compensation costs *(Notes 2 and 3)* | **6,324** | 5,815 |
| Employees' accumulated leave | **1,932** | 2,088 |
| Other | **1,026** | 1,182 |
| Total other liabilities | **9,282** | 39,131 |
| Commitments and contingencies *(Notes 9 and 10)* | | |
| Total liabilities | **26,376** | 62,017 |
| Net capital (deficiency): | | |
| Capital contributions of the U.S. government | **3,034** | 3,034 |
| Deficit since reorganization | **(2,168)** | (6,036) |
| Total net capital (deficiency) | **866** | (3,002) |
| Total liabilities and net capital deficiency | **$ 27,242** | $ 59,015 |

*See accompanying notes.*

## United States Postal Service

## Statements of Operations

| | Year ended September 30 | | |
|---|---|---|---|
| | **2003** | **2002** | **2001** |
| | | *(In Millions)* | |
| Operating revenue *(Note 8)* | **$68,529** | $66,463 | $65,834 |
| Operating expenses: | | | |
| Compensation and benefits *(Notes 2, 3, 6, and 7)* | **50,428** | 51,557 | 51,351 |
| Transportation | **4,989** | 5,132 | 5,056 |
| Other | **8,485** | 8,545 | 9,233 |
| Total operating expenses | **63,902** | 65,234 | 65,640 |
| Income from operations | **4,627** | 1,229 | 194 |
| Interest and investment income | **58** | 46 | 35 |
| Interest expense on deferred retirement liabilities *(Notes 6 and 7)* | **(116)** | (1,601) | (1,603) |
| Interest expense on borrowings | **(334)** | (340) | (306) |
| Debt repurchase expense | **(360)** | – | – |
| Emergency preparedness appropriations (*Note 11)* | **177** | 179 | – |
| Emergency preparedness expenses *(Note 11)* | **(184)** | (189) | – |
| Net income (loss) | **$ 3,868** | $ (676) | $ (1,680) |

*See accompanying notes.*

United States Postal Service

Statements of Changes in Net Capital (Deficiency)

| | **Capital Contributions of U.S. Government** | **Deficit Since Reorganization** | **Total Net Capital (Deficiency)** |
|---|---|---|---|
| | | *(In Millions)* | |
| Balance, September 30, 2000 | $ 3,034 | $(3,680) | $ (646) |
| Net loss | – | (1,680) | (1,680) |
| Balance, September 30, 2001 | 3,034 | (5,360) | (2,326) |
| Net loss | – | (676) | (676) |
| Balance, September 30, 2002 | 3,034 | (6,036) | (3,002) |
| Net income | – | **3,868** | **3,868** |
| Balance, September 30, 2003 | **$ 3,034** | **$(2,168)** | **$ 866** |

*See accompanying notes.*

## United States Postal Service

## Statements of Cash Flows

| | Year ended September 30 | | |
|---|---|---|---|
| | **2003** | **2002** | **2001** |
| | | *(In Millions)* | |
| **Cash flows from operating activities** | | | |
| Net income (loss) | **$ 3,868** | $ (676) | $(1,680) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | | |
| Depreciation and amortization | **2,295** | 2,296 | 2,223 |
| Loss on disposals of property and equipment, net | **64** | 6* | 16 |
| Decrease in other assets, principally revenue forgone appropriations receivable | **3** | 4 | 3 |
| Increase in USPS workers' compensation | **589** | 721 | 244 |
| (Decrease) increase in Post Office Department workers' compensation | **(63)** | 13 | (21) |
| (Decrease) increase in employees' accumulated leave | **(156)** | (36) | 34 |
| (Decrease) increase in other liabilities | **(156)** | 196 | 167 |
| Changes in current assets and liabilities: | | | |
| Increase in receivables, net | **(394)** | (189) | (19) |
| (Increase) decrease in supplies, advances and prepayments | **(39)** | (7) | 63 |
| (Decrease) increase in compensation and benefits | **(427)** | (877) | 310 |
| (Decrease) increase in estimated prepaid postage | **(151)** | (123) | 29 |
| Increase (decrease) in payables and accrued expenses | **1,276** | (28) | (283) |
| (Decrease) increase in prepaid box rentals, permit and metered mail | **(86)** | 145 | (103) |
| (Decrease) increase in outstanding postal money orders | **(218)** | (2) | 272 |
| Net cash provided by operating activities | **6,405** | 1,443* | 1,255 |
| **Cash flows from investing activities** | | | |
| Purchase of property and equipment | **(1,314)** | (1,705) | (2,961) |
| Proceeds from sale of property and equipment | **37** | 30* | 29 |
| Net cash used in investing activities | **(1,277)** | (1,675)* | (2,932) |
| **Cash flows from financing activities** | | | |
| U.S. government appropriations—received | **–** | 762 | – |
| U.S. government appropriations—expended | **(177)** | (179) | – |
| Issuance of debt | **4,609** | 2,700 | 5,651 |
| Payments on debt | **(8,450)** | (2,900) | (3,652) |
| Net cash (used in) provided by financing activities | **(4,018)** | 383 | 1,999 |
| Net increase in cash and cash equivalents | **1,110** | 151 | 322 |
| Cash and cash equivalents at beginning of year | **1,156** | 1,005 | 683 |
| Cash and cash equivalents at end of year | **$ 2,266** | $ 1,156 | $ 1,005 |

* *Restatement of prior year.*

*See accompanying notes.*

United States Postal Service

Notes to Financial Statements

September 30, 2003

## 1. Description of Business

### Nature of Operations

The United States Postal Service (Postal Service) provides mail service to the public, offering a variety of classes of mail services without discrimination among its many customers. This means that within each class of mail our price does not vary by customer for the levels of service we provide. This fulfills our legal mandate to offer universal services at a fair price. Our primary lines of business are First-Class Mail, Standard Mail, Priority Mail, Periodicals and Package Services. The principal markets for these services are the communications, distribution and delivery, advertising and retail markets. Our products are distributed through our nearly 37,000 post offices and a large network of consignees. As in the past, we continue to conduct our significant operations primarily in the domestic market, with international operations representing less than 3% of total revenue.

Our labor force is primarily represented by the American Postal Workers Union, National Association of Letter Carriers, National Postal Mail Handlers Union and National Rural Letter Carriers Association. Almost 90% of our career employees are covered by collective bargaining agreements. The agreements with the major unions expire between November 20, 2004 and November 20, 2006.

### Postal Reorganization

The Postal Service commenced operations on July 1, 1971, in accordance with the provisions of the Postal Reorganization Act (the Act). The equity that the U.S. government held in the former Post Office Department became the initial capital of the Postal Service. The Postal Service valued the assets of the former Post Office Department at original cost less accumulated depreciation. The initial transfer of assets, including property, equipment and cash, totaled $1.7 billion. Subsequent cash contributions and transfers of assets between 1973 and 1982 totaled approximately $1.3 billion, resulting in total government contributions of approximately $3 billion. The U.S. government remained responsible for all the liabilities attributable to operations of the former Post Office Department. However, under the Balanced Budget Act of 1997, the remaining liability for Post Office Department workers' compensation costs was transferred to the Postal Service.

Although the Postal Service is excluded from the U.S. government budgetary process, the Postal Service enters into significant transactions with other government agencies, as disclosed throughout these financial statements.

## 1. Description of Business (continued)

### Price Setting Process

Since 1971, the Act has required the Postal Service to establish prices that cover the costs of operating the postal system. The Act established the independent Postal Rate Commission with oversight responsibility for mail prices, subject to approval by the Governors of the Postal Service. The Act provides for the recovery of financial losses through future rate increases.

## 2. Summary of Significant Accounting Policies

### Basis of Accounting and Use of Estimates

We maintain our accounting records and prepare our financial statements on the accrual basis of accounting. This basis conforms to accounting principles generally accepted in the United States. Following these principles, we made estimates and assumptions that affect the amounts we report in the financial statements and notes. Actual results may differ from our estimates.

### Cash Equivalents

Cash equivalents are securities that mature within 90 days or less from the date we buy them. We recognize checks outstanding as a current liability until presented for payment.

### Current Values of Financial Instruments

The current value of our debt is what it would cost to pay off the debt if we used the current yield on equivalent U.S. Treasury debt.

We have foreign currency risk related to the settlement of terminal dues and transit fees with foreign postal administrations for international mail. The majority of our international accounts are denominated in Special Drawing Rights (SDRs). The SDR exchange rate fluctuates daily based on a basket of currencies comprised of the euro, Japanese yen, the pound sterling and the U.S. dollar. Changes in the relative value of these currencies will increase or decrease the value of our settlement accounts and result in a gain or loss from revaluation reported in the results from operations. The actual currency used to settle accounts varies by country.

**2. Summary of Significant Accounting Policies (continued)**

**Current Values of Financial Instruments (continued)**

The loss recorded on the statement of operations from this revaluation was $9 million in 2003, $7 million in 2002 and $0 in 2001. In addition to the year-end revaluation, we also recognize gains and losses on our payables and receivables when we settle with foreign postal administrations. The impact on the statement of operations from these settlement losses was $12 million in 2003, $7 million in 2002 and $7 million in 2001.

**Supplies, Advances and Prepayments**

Supplies, advances and prepayments are primarily composed of our inventories of supplies, motor vehicle parts, parts for mail processing equipment and advances to employees for annual leave. We value our inventories at the lower of average cost or current market price. Total inventories amounted to $123 million at the end of 2003 and $136 million at the end of 2002.

**Property and Equipment**

We record property and equipment at what it costs us to acquire the assets, including the interest we pay on the money we borrow to pay for the construction of major capital additions. This interest amounted to $1 million in 2003, $23 million in 2002 and $50 million in 2001. Repairs and maintenance are charged to expense as incurred. This expense amounted to $692 million in 2003, $577 million in 2002 and $600 million in 2001.

We depreciate buildings and equipment over their estimated useful lives, which range from 3 to 75 years, using the straight-line method. We amortize leasehold improvements over the period of the lease or the useful life of the improvement, whichever time is shorter.

**Impaired Assets**

We record losses on long-lived assets when events and circumstances indicate that the assets might be impaired. In accordance with FAS Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, we have written down our impaired assets to the lower of cost or fair value. No material impairments were recorded in 2003, 2002 or 2001.

## 2. Summary of Significant Accounting Policies (continued)

### Allowance for Doubtful Accounts

We provide an allowance for doubtful accounts in our outstanding receivables based on our collection history and an estimate of uncollectible accounts.

### Revenue Recognition/Estimated Prepaid Postage

We recognize revenue when service is rendered. Estimated prepaid postage is the amount of cash we estimate that we collected by the end of the year for services that we will perform in the following year. In 2002, after extensive analysis, we changed our estimate of the sampling period for meter customers from 92 days to 30 days to more closely reflect the meter resetting practices of our customers. The impact of this change in estimate was a $113 million reduction of the liability in 2002.

### Compensation and Benefits Payable

These are the salaries and benefits we owe to current and retired employees, including the amounts employees have earned but have not yet been paid, current workers' compensation, unemployment costs, health benefits and the current portion of the amounts payable for retirement benefits.

### Deferred Retirement Benefits and Costs

We are an independent establishment of the executive branch of the U.S. government. We provide pension benefits as defined by the Office of Personnel Management (OPM) and, therefore, have a parent-subsidiary type relationship. We accounted for our participation in the U.S. government-sponsored retirement plans as a participant in a multiemployer plan arrangement in accordance with FAS 87, *Employer's Accounting For Pensions* (see Notes 6 and 7).

### Postretirement Health Benefits

Retiree health benefits costs are those obligations we pay as a portion of the health insurance premiums of those retirees and their survivors who participate in the Federal Employees Health Benefits Program (FEHBP). We account for our participation in FEHBP as a participant in a multiemployer plan arrangement. Therefore, the costs of retiree health benefits are expensed as we incur them (see Note 4).

## 2. Summary of Significant Accounting Policies (continued)

### Workers' Compensation Costs

We are self-insured for workers' compensation costs under a program administered by the Department of Labor (DOL). We record these costs, which include the injured's medical expenses and payment for continuation of wages, as an operating expense.

At the end of the year, our liability represents the estimated present value of the total amounts we expect to pay in the future for postal workers injured through the end of 2003. In our calculation of present value, a net discount rate of 1.4% for medical expenses and 3.0% for compensation claims is used.

The estimate of the total costs of a claim is based upon the severity of the injury, the age of the injured employee, the assumed life expectancy of the employee, the trend of our experience with such an injury and other factors (see Note 3).

### Emergency Preparedness Appropriations

Emergency preparedness appropriations are the funds received from the federal government to help pay the costs to keep the mail, postal employees and postal customers safe. Upon receipt of the funds, we establish a liability. Upon use of the funds, we recognize nonoperating revenue to the extent of the expenditure. Appropriations received for capital equipment will be offset against depreciation expense over the life of the equipment (see Note 11).

## 3. Workers' Compensation

At the end of 2003, we estimate our total liability for future workers' compensation costs, excluding the Post Office Department (POD) liability, at $7,114 million. At the end of 2002, this liability was $6,525 million. The payout period for this liability will, for some claimants currently on the rolls, be for the rest of their lives. The liability is sensitive to changes in inflation and discount rates. A change of 1% in the assumptions would change our estimate of the liability by approximately $600 million.

In 2003, we recorded $1,457 million in workers' compensation expense, compared to the $1,511 million we recorded in 2002 and the $970 million we recorded in 2001. Our liability for future workers' compensation costs for POD claims was $122 million in 2003 and $185 million in 2002. In 2003, we recorded an expense of $17 million for POD, compared to the $13 million we recorded in 2002 and $9 million in 2001.

**4. Health Benefit Programs**

Career employees of the Postal Service are covered by the U.S. government health plan, the Federal Employees Health Benefits Program (FEHBP). OPM administers the program and allocates the cost of the program to the various participating employers. Our portion of the cost is based upon the average premium cost of the various employee coverage choices and the specific coverage choices made by our employees. The employees of the Postal Service pay for 16.7% of the cost in 2003, and we paid the remainder.

Employees of the Postal Service who participate in FEHBP for at least the five years immediately before their retirement may participate in FEHBP during their retirement. The Omnibus Budget Reconciliation Act of 1990 requires us to pay the employer's share of health insurance premiums for all employees and their survivors, who participate in FEHBP and who retire on or after July 1, 1971. However, we do not include the costs attributable to Federal civilian service before that date.

We account for postretirement health benefits as a participant in a multiemployer plan arrangement in accordance with the Statement of Financial Accounting Standards (FAS) 106, *Employers' Accounting for Postemployment Benefits Other Than Pensions*. Our retiree FEHBP costs amounted to $1,133 million in 2003, $987 million in 2002 and $858 million in 2001. We include these costs in our compensation and benefits expense.

**5. Debt and Related Interest Costs**

Under the Postal Reorganization Act, as amended by Public Law 101-227, we can issue debt obligations. However, we are limited to net annual increases of $2 billion in our debt for capital improvements and to $1 billion for operating expenses. Our total debt cannot exceed $15 billion.

Debt is due as follows (dollars in millions):

| Year | Amount |
|---|---|
| 2004 | $ 7,273 |
| After 2008 | 1 |
| Total | $ 7,274 |

Cash outlays for interest were $426 million in 2003, $339 million in 2002 and $339 million in 2001.

**5. Debt and Related Interest Costs (continued)**

In January, July and August 2003, we repaid debt with maturity dates that extended to 2031. In connection with the August transaction, we paid a premium (debt repurchase expense) of $360 million, which was expensed when incurred.

At year-end, the current estimated market value of our debt is $7,283 million in 2003 and $11,991 million in 2002 (see Note 2). All notes payable to the Federal Financing Bank (FFB) may be repurchased at current value at any time with five days' notice of intent to do so.

## 5. Debt and Related Interest Costs (continued)

Our debt consists of the following (dollars in millions):

| Interest Rate % | Terms * | September 30 2003 | September 30 2002 |
|---|---|---|---|
| **Notes payable to the Federal Financing Bank (FFB):** | | | |
| 1.167 | Payable February 5, 2004 | $ 2,000 | $ – |
| 1.195 | Payable February 17, 2004 | 250 | – |
| 1.084 | Floating rate; payable August 15, 2004 | 1,750 | – |
| 1.026** | Short-term, floating rate, revolving credit facility; final maturity date May 6, 2005 and May 9, 2004 | 3,273 | 2,450 |
| 1.729 | Overnight revolving credit facility; final maturity date May 10, 2003 | – | 214 |
| 5.568 | Payable December 31, 2002 | – | 200 |
| 4.543 | Payable February 28, 2003 | – | 200 |
| 3.858 | Payable July 31, 2003 | – | 750 |
| 3.636 | Payable February 15, 2005 | – | 300 |
| 4.780 | Payable November 15, 2005 | – | 200 |
| 5.412 | Payable November 15, 2005 | – | 500 |
| 4.437 | Payable May 15, 2006 | – | 250 |
| 4.325 | Payable November 15, 2006 | – | 200 |
| 3.449 | Payable May 15, 2007 | – | 250 |
| 3.714 | Payable May 15, 2007 | – | 250 |
| 5.688 | Payable August 15, 2007 | – | 400 |
| 5.546 | Payable August 15, 2007 | – | 150 |
| 5.426 | Payable May 15, 2008 | – | 200 |
| 4.981 | Payable May 15, 2008 | – | 200 |
| 4.910 | Payable May 15, 2008 | – | 200 |
| 4.806 | Payable November 17, 2008 | – | 300 |
| 5.355 | Payable August 16, 2010 | – | 500 |
| 4.999 | Payable February 15, 2011 | – | 200 |
| 4.925 | Payable August 15, 2011 | – | 200 |
| 4.414 | Payable February 15, 2012 | – | 250 |
| 4.594 | Payable February 15, 2012 | – | 250 |
| 5.012 | Payable February 15, 2012 | – | 200 |
| 3.903 | Payable August 15, 2011 | – | 250 |
| 5.959 | Payable November 15, 2027 | – | 400 |
| 5.726 | Payable November 15, 2027 | – | 100 |
| 5.606 | Payable November 15, 2027 | – | 300 |
| 4.836 | Payable November 15, 2027 | – | 100 |
| 6.299 | Payable May 15, 2030 | – | 250 |
| 5.591 | Payable May 15, 2030 | – | 250 |
| 5.417 | Payable February 18, 2031 | – | 200 |
| 4.976 | Payable February 18, 2031 | – | 250 |
| 5.552 | Payable February 18, 2031 | – | 200 |
| | | 7,273 | 11,114 |
| **Mortgage Notes Payable** | | | |
| 5.00 to 9.25 | Maturing from years 2004 through 2039 secured by land, buildings and equipment with a carrying amount of $6.7 million. | 1 | 1 |
| | | 7,274 | 11,115 |
| Less current portion of debt | | 7,273 | 3,815 |
| | | $ 1 | $ 7,300 |

* All debt is repurchasable at any time at a price determined by the current FFB rates.

** Weighted-average interest rate; prior year's interest rate was 1.790%

**6. Retirement Programs**

Our employees, retirees and their survivors participate in a pension program of the U.S. government. As an "independent establishment" of the U.S. government, we account for our involvement in these programs as participation in a multiemployer plan arrangement, in accordance with the Statement of Financial Accounting Standards (FAS) 87, *Employers' Accounting for Pensions*.

With certain exceptions, employees participate in one of the following three retirement programs based upon the starting date of their employment with the Postal Service. Employee and employer contributions are made to the Civil Service Retirement System, the Dual System or the Federal Employees Retirement System, which are administered by OPM. Employees may also participate in the Thrift Savings Plan, which is a defined contribution retirement savings and investment plan. Postal Service employees are authorized to participate in the Thrift Savings Plan by the Federal Employees Retirement System Act of 1986. The Plan is administered by the Federal Retirement Thrift Investment Board.

**Civil Service Retirement System (CSRS)**

Under the Postal Reorganization Act, officers and career employees hired prior to January 1, 1984 are covered by the Civil Service Retirement System (CSRS), which provides a basic annuity. We do not match contributions to the Thrift Savings Plan for employees who participate in CSRS.

**Dual Civil Service Retirement System (Dual CSRS)/Social Security System**

Employees with prior U.S. government service who were hired between January 1, 1984, and January 1, 1987, are covered by the Dual Civil Service Retirement System/Social Security System. We and the employee contribute to Social Security at the rate prescribed by law. We do not match contributions to the Thrift Savings Plan for employees who participate in the Dual System.

**Federal Employees Retirement System (FERS)**

Effective January 1, 1987, officers and career employees hired since December 31, 1983, except those covered by the Dual System, are covered by the Federal Employees Retirement System Act of 1986. In addition, employees hired before January 1, 1984, could choose during certain periods in 1987, 1988 and 1998 to participate in the FERS. This system consists of Social Security, a basic annuity plan, and a Thrift Savings Plan.

## 6. Retirement Programs (continued)

### Federal Employees Retirement System (FERS) (continued)

We and the employee contribute to Social Security at the rate prescribed by law. In addition, we are required to contribute to the Thrift Savings Plan a minimum of 1% per year of the basic pay of employees covered by this system. We also match a voluntary employee contribution up to 3% of the employee's basic pay, and 50% of a contribution between 3% and 5% of basic pay.

Employer and employee base contributions, as a percentage of employee compensation, are as follows for each of the three plans for 2003, 2002 and 2001:

| | **2003** | **2002** | **2001** |
|---|---|---|---|
| CSRS | | | |
| Employer | **17.40*** | 7.00 | 7.00 |
| Employee | **7.00** | 7.00 | 7.00 |
| Dual CSRS | | | |
| Employer | **17.40*** | 7.00 | 7.00 |
| Employee | **0.80** | 0.80 | 0.80 |
| FERS | | | |
| Employer | **10.70** | 10.70 | 10.70 |
| Employee | **0.80** | 0.80 | 0.80 |

* As of May 2003, Public Law 108-18 changed our base contribution level for the CSRS (see Note 7).

The number of employees enrolled in each of the retirement plans at the end of 2003, 2002 and 2001 is as follows:

| | **2003** | **2002** | **2001** |
|---|---|---|---|
| CSRS | **211,913** | 230,632 | 248,347 |
| Dual CSRS | **10,122** | 10,828 | 11,440 |
| FERS | **505,728** | 510,237 | 514,870 |

## 6. Retirement Programs (continued)

### Deferred Retirement Liability—Civil Service Retirement System

Prior to Public Law 108-18 (see Note 7), when we increased CSRS employees' current basic pay we were liable for the estimated additional deferred retirement liability. OPM determined and billed us for the current portion of the increase in the estimated deferred liability of the Civil Service Retirement and Disability Fund (CSRDF) resulting from basic pay increases. We expensed as billed those amounts as they became payable in 30 equal annual installments, which included interest computed at a rate of 5% per year. We made the first payment at the end of the year in which employees received their pay increase.

The increase in our deferred liability for retirement benefits under the CSRS as a result of basic pay increases was $1,153 million in 2002 and $313 million in 2001.

### Deferred Retirement Liability—Retirees' and Their Survivors' Cost of Living Adjustments (COLAs)

OPM determines the COLAs granted by Congress to our retirees. Under the Omnibus Budget Reconciliation Act of 1990, we were liable, by law, for our share of the COLAs granted to those retirees, and their survivors, retiring on or after July 1, 1971. We were not responsible for any costs due to federal civilian service before that date.

Prior to Public Law 108-18 (see Note 7) each year OPM determined the current portion of the increase in our share of the estimated liability of the CSRDF and billed us for COLAs granted for the current year. We expensed those billed amounts as they became payable in 15 equal annual installments, which included interest computed at a rate of 5% per year.

The increase in our deferred liability for our retirees' COLAs was $1,329 million in 2002 and $1,668 million in 2001.

### Deferred Retirement Costs

We have expensed all billed amounts for CSRS through 2002. The amounts reported as a deferred asset and a deferred liability on the balance sheet for 2002 represented OPM's calculation of the amounts payable in the future.

## 6. Retirement Programs (continued)

### Deferred Retirement Costs (continued)

Deferred retirement costs consisted of the following (dollars in millions):

| | 2002 |
|---|---|
| CSRS | $ 24,602 |
| CSRS retirees' and survivors' cost of living adjustments | 7,629 |
| Total | $ 32,231 |

There are no deferred retirement costs associated with FERS. For information on supplemental costs of CSRS after April 2003 see Note 7.

### Expense Components

The following table lists the components of our total retirement expenses that are included in our compensation and benefits expense and related interest expense in the Statements of Operations for 2003, 2002 and 2001 (dollars in millions):

| | 2003 | 2002 | 2001 |
|---|---|---|---|
| CSRS | **$ 1,128** | $ 740 | $ 769 |
| FERS | **2,172** | 2,121 | 2,046 |
| FERS—Thrift Savings Plan | **856** | 827 | 789 |
| Dual CSRS | **52** | 33 | 33 |
| Social Security | **1,544** | 1,511 | 1,498 |
| Accrued Postal Supplemental Liability | **9** | – | – |
| Amortization of deferred cost: | | | |
| CSRS | **–** | 1,393 | 1,333 |
| Annuitant COLAs | **–** | 879 | 814 |
| Interest expense on deferred liabilities | **116** | 1,601 | 1,603 |
| Total retirement expense | **$ 5,877** | $ 9,105 | $ 8,885 |

Employer cash contributions to retirement plans were $4,031 million in 2003, $6,013 million in 2002 and $5,799 million in 2001. These amounts do not include Social Security contributions and interest expense on deferred retirement liabilities.

## 7. The Postal Civil Service Retirement System Funding Reform Act of 2003—Public Law 108-18

On April 23, 2003, the President signed into law Postal Civil Service Retirement System Funding Reform Act of 2003—Public Law 108-18 (PL108-18), which changed the way we fund our CSRS retirement plan. Although the law changed the funding of the plan, postal management determined that we are still a participant in a multiemployer pension plan. The parent-subsidiary relationship that we have as an "independent establishment" of the executive branch of the United States government allows for this accounting treatment under FAS 87. As a "subsidiary" we cannot direct the costs, benefits or funding requirements of the federally sponsored plan.

In November 2002, OPM advised us that it had completed a review of estimates and our then current scheduled funding of CSRDF. OPM determined that at our current rate of funding, we would pay substantially more than would be needed to cover the future benefits expected to be paid to our employees and retirees participating in CSRS. The projected over-funding was mostly due to the excess interest earned by the fund; that is, interest earnings in excess of the 5% that was assumed under the statutory funding method. A subsequent GAO report stated that were it not for the transfer of the cost of military service to us, the plan was already overfunded by approximately \$6 billion. Adding the present value of participant future contributions increases the overfunding to \$10 billion.

Because of OPM's projection of significant over-funding, the Administration proposed PL108-18.

As part of PL108-18, in May 2003 we began to dynamically fund the plan at 17.4% of our current CSRS employees' wages. The Act further requires that the Postal Service pay an additional annual amount, if necessary, each September beginning 2004 as determined by OPM. The additional amount is based on a calculation of any potential "supplemental liability," if one exists. It would represent the excess of the actuarial present value of future benefits over the actuarial present value of future contributions, earnings, and other actuarial factors related to postal participants in the CSRS plan. Such additional obligations may result due to the deviation of actual results from valuation assumptions used by OPM to determine the CSRS base contributions. Pursuant to PL 108-18, commencing September 30, 2004, we will pay each September 30th a portion of the calculated supplemental liability, if any, sufficient to fully fund the amount in 40 years after the enactment of the law. Under multiemployer plan accounting, such amounts will be recognized by us when payable.

**7. The Postal Civil Service Retirement System Funding Reform Act of 2003—Public Law 108-18 (continued)**

OPM's original estimate of the "supplemental liability" of $4.8 billion as of September 30, 2002, assumed the dynamic funding of the plan starting October 1, 2002. Since the law went into effect April 23, 2003, and the first payment of our supplemental deferred liability, if necessary, will not be due until September 30, 2004, we estimated, and OPM confirmed, that the present value of the liability increased to $5.8 billion as of September 2003. The increase adds interest to the prior balance at 6.75% and calculates an additional liability due to the delayed start in dynamic funding. Under the law OPM is not required to furnish the final actuarial calculation of the September 30, 2003 liability until June 30, 2004. OPM will recalculate the supplemental liability, if any, on an annual basis. Each September 30th, we will make any required payment resulting from this calculation.

OPM's 2002 assumptions of 3.75% annual CPI, 4.25% annual salary increases and 6.75% annual interest used in calculating the supplemental liability are not postal specific and do not reflect the most current experience. OPM advised that the actual inflation adjustments were 1.4% for 2003 and 2.1% for 2004. We anticipate these adjustments will be included in OPM's new calculation of the September 30, 2003, supplemental liability estimate if any exists. On September 30, 2004, we will be required to make any necessary payment to the CSRDF. We estimated the September 30, 2004 amount payable based upon the OPM estimate of the supplemental liability and began accruing that payable over the period from the enactment of the law to September 30, 2004. The related expense in 2003 amounted to $125 million.

Our previously recorded deferred retirement cost liability and equal asset offset were removed from our balance sheet effective on the date the law was enacted. Under prior law, the liability represented the total amount of fixed payments to CSRDF as determined by OPM. The potential liability under the new law is variable in nature. Therefore, we are disclosing information on any potential supplemental liability in these notes.

**8. Revenue Forgone**

Our operating revenue includes accruals for revenue forgone. Revenue is forgone when Congress mandates that we provide free mail for certain mailers. Congress appropriated money to reimburse us for the revenue that we have forgone in providing these services. In our operating revenue, we have included as revenue the amounts appropriated by Congress for revenue forgone of $31 million for 2003, $48 million for 2002 and $67 million for 2001. Legislation enacted in 2002 and 2001 delayed payment of the

## 8. Revenue Forgone (continued)

amount authorized for 2003 and 2002 until the first day of the subsequent fiscal year, respectively. Accordingly, the Postal Service has recorded these amounts as a receivable at year-end.

Under the Revenue Forgone Reform Act of 1993, Congress is required to reimburse us $29 million annually through 2035 (42 years). This reimbursement is for two purposes: services we performed in 1991, 1992 and 1993 for which we have not yet been paid; and for shortfalls in the reimbursement for the costs we incurred for processing and delivering certain nonprofit mail from 1994 through 1998.

The Revenue Forgone Reform Act of 1993 authorized a total of $1.218 billion in payments. We calculated the present value of these future reimbursements to be approximately $390 million at 7% interest. We recognized the $390 million as revenue during fiscal years 1991 through 1998. The amounts receivable as of September 30, 2003 and 2002 were $367 million and $370 million, respectively.

## 9. Commitments

At September 30, 2003, we estimate our financial commitment for approved capital projects in progress to be approximately $2,395 million.

Our total rental expense for the years ended September 30 is summarized as follows (dollars in millions):

| | **2003** | **2002** | **2001** |
|---|---|---|---|
| Noncancelable real estate leases including related taxes | **$ 923** | $ 894 | $ 863 |
| Facilities leased from General Services Administration subject to 120-day notice of cancellation | **53** | 45 | 41 |
| Equipment and other short-term rentals | **201** | 214 | 312 |
| Total | **$ 1,177** | $ 1,153 | $ 1,216 |

**9. Commitments (continued)**

At September 30, 2003, our future minimum lease payments for all noncancelable leases are as follows (dollars in millions):

| Year | Operating | Capital |
|---|---|---|
| 2004 | $ 718 | $ 80 |
| 2005 | 679 | 80 |
| 2006 | 631 | 80 |
| 2007 | 580 | 80 |
| 2008 | 560 | 80 |
| After 2008 | 5,500 | 562 |
| | $ 8,668 | 962 |
| Less: Interest at 4.5% | | 220 |
| Total capital lease obligations | | 742 |
| Less: Short-term portion of capital lease obligations | | 48 |
| Long-term portion of capital lease obligations | | $ 694 |

Most of these leases contain renewal options for periods ranging from 3 to 20 years. Certain noncancelable real estate leases give us the option to purchase the facilities at prices specified in the leases.

Capital leases included in buildings were $963 million in 2003 and $1,038 million in 2002. Total accumulated amortization is $259 million in 2003 and $264 million in 2002. Amortization expense for assets recorded under capital leases is included in depreciation expense.

**10. Contingent Liabilities**

Each quarter we review litigation pending against us. As a result of this review, we classify and adjust our contingencies for claims that we think it probable that we will pay and for which we can reasonably estimate the amount of the unfavorable outcome.

These claims cover labor, equal employment opportunity, environmental issues, traffic accidents, injuries on postal properties, personal claims and property damages and suits and claims arising from postal contracts. We also recognize the settlements of claims and lawsuits and revisions of other estimates. Additionally, we evaluate the materiality of cases determined to have a reasonably possible chance of adverse outcome. Such cases are immaterial to our financial statements taken as a whole.

**10. Contingent Liabilities (continued)**

As a part of our continuing evaluation of estimates required in the preparation of management's financial statements, we recorded a $92 million decrease in the contingent liabilities balance in 2003, compared to an increase of $187 million in 2002 and a $88 million increase in 2001. We recognized settlements, payments and changes in estimates of claims and lawsuits in our changes in contingent liabilities. Management and General Counsel believe that we have made adequate provision for the amounts that may become due under the suits, claims and proceedings we have discussed here.

**11. Emergency Preparedness Funding**

In October 2001, the United States became the target of biological terrorism. These activities affected us because infectious biological agents were sent by mail, resulting in the death of two employees, the curtailment of mail services in some areas, long-term closing of two processing facilities and a decline in mail volume. Our viability and our value to the American people are dependent upon an open and accessible system. It was critical to put in place process changes and technology applications that can reduce risks for both employees and customers.

The President of the United States authorized an initial funding of $175 million for 2002 to assist in paying for these safety measures. In November 2001, Congress appropriated an additional $500 million to "protect postal employees and postal customers from exposure to biohazardous material, to sanitize and screen the mail and to replace or repair postal facilities destroyed or damaged in New York City as a result of the September 11, 2001, terrorist attacks." Our use of the funds provided by this appropriation was contingent on the submission of an emergency preparedness plan to combat the threat of biohazards in the mail. We submitted the required Emergency Preparedness Plan in March 2002.

In August 2002, as set forth in our Emergency Preparedness Plan, Congress appropriated an additional $87 million to us for emergency expenses to further protect postal employees and customers from exposure to biohazardous material and to sanitize and screen the mail.

All three appropriations are to remain available until expended for purposes approved by Congress. We are required to submit quarterly expenditure plans on the obligation as well as continued annual updates of the Emergency Preparedness Plan. We have submitted all required plans and updates. Unspent funds that are not reallocated with Congressional approval are required to be returned to the United States Treasury.

### 11. Emergency Preparedness Funding (continued)

The appropriations during 2003 and 2002 that have been expended or committed are as follows (dollars in millions):

| | 2003 | 2002 |
|---|---|---|
| Operating expenses | **$ –** | $ 16 |
| Nonoperating expenses | **177** | 163 |
| Capital equipment | **189** | 38 |
| Total | **$ 366** | $ 217 |

Detection and filtration systems are being tested and evaluated and will then be deployed in 2004 and beyond. The amounts expected to be spent in future years, although we have not been appropriated the total amount, are as follows (dollars in millions):

| | |
|---|---|
| Building restoration | $ 85 |
| Biohazard detection system | 223 |
| Ventilation and filtration | 632 |
| Miscellaneous | 18 |
| | $ 958 |

Our Emergency Preparedness expenditures are not all covered by the appropriations we received. The Emergency Preparedness expenses for the years ended September 30 are as follows (dollars in millions):

| | 2003 | 2002 |
|---|---|---|
| Operating expenses: | | |
| Personnel costs | **$ 12** | $ 73 |
| Total operating costs | **12** | 73 |
| Nonoperating expenses: | | |
| Safety measures | **15** | 128 |
| Research and development | **3** | 5 |
| Building restoration | **125** | 54 |
| Miscellaneous | **41** | 2 |
| Total nonoperating expenses | **184** | 189 |
| | **$ 196** | $ 262 |

**11. Emergency Preparedness Funding (continued)**

We recognize the appropriations as income in the year in which the related expenditure is recognized as an expense or when the government approves the reimbursement of a previously incurred expense. The Emergency Preparedness appropriations revenues recognized during the years ended September 30 are as follows (dollars in millions):

| | **2003** | 2002 |
|---|---|---|
| Personnel costs | **$ –** | $ 16 |
| Safety measures | **–** | 121 |
| Research and development | **3** | 5 |
| Building restoration | **135** | 35 |
| Miscellaneous | **39** | 2 |
| | **$ 177** | $ 179 |

As a result, the funds that had not been spent or reallocated as of September 30, 2003 and 2002 of $406 million and $583 million, respectively, are reflected in our Balance Sheets as a non-interest-bearing liability and have been reflected in the 2003 and 2002 Statements of Cash Flows as a financing activity.

The funds spent in 2002 were for irradiation equipment that did not meet our needs. With the approval of OMB, six of the eight machines valued at $17 million were transferred to other government and public agencies, and the manufacturer provided us with a more powerful machine at no additional cost. This new machine is valued at $14 million and is to be deployed at a future date.